

# International Financial Products & Services Committee Newsletter

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## ESMA - POWERS AND EVOLUTION



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### Why Was ESMA Brought Into Force

In accordance with Regulation (EU) No 1095/2010 of the European Parliament (the “Regulation”), the financial crisis of 2007 and 2008 exposed “shortcomings in financial supervision, both in particular cases and in relation to the financial system as a whole”. In particular, the financial crisis highlighted that national supervision of a cross border industry offered a piecemeal regulatory solution with too many opportunities to fall through the cracks.

In response to the highlighted issue, the European Commission sought to impose a new regime of financial supervision encouraging “cooperation, coordination, consistent application of Union law and trust between national supervisors”<sup>1</sup>. This new supervision regime was to ensure a level playing field between EU Member States, and for all market participants acting within the European Union (“EU”).

### Emergence of ESMA

In response to the issues raised by the financial crisis, the European Commission mandated a group to make recommendations on how to strengthen existing European supervisory arrangements, which group presented the “de Larosiere Report” (the “Report”) recommending reforms to the structure of supervision of the financial sector in the European Union.

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<sup>1</sup> Regulation (EU) No 1095/2010 – Recital 1

The Report recommended the creation of a European System of Financial Supervisors, comprising three European Supervisory Authorities, one for the banking sector, one for the securities sector, and one for the insurance and occupational pensions sector. Following its review of the Report, the European Commission accepted that three new European supervisory authorities should be established, and that the European Securities and Markets Authority (“ESMA”), be created in respect of the securities sector, with appropriate powers of investigation and enforcement, as well as the possibility of charging fees. ESMA would replace the Committee of European Securities Regulators<sup>2</sup> (known as “CESR”) and would be accountable to the European Parliament and the European Council.

ESMA, the “European Securities Markets Association” came into force on 1<sup>st</sup> January 2011<sup>3</sup> as an independent EU Authority charged with safeguarding the stability of the EU’s financial system and with a mandate to improve the “functioning of the internal market, in particular by ensuring a high, effective and consistent level of regulation and supervision...” ESMA is also charged with preventing regulatory arbitrage, guaranteeing a level playing field, strengthening international supervisory cooperation, promoting supervisory convergence and providing advice to the Union institutions in the areas of its responsibility.

### Who is ESMA?

There are two bodies in ESMA’s governance structure, the Board of Supervisors, and the Management Board.

The Board of Supervisors, which meets at least twice a year, is comprised of the head of each relevant financial regulatory authority of each Member State, together with one observer from the European Commission, a representative of EBA and EIOPA and one representative of the ESRB.

The Board of Supervisors takes all policy decisions of ESMA and also takes final decision on ESMA’s budget. Voting is undertaken by way of simple majority, save for votes on guidelines and technical standards which are undertaken by a qualified majority.

The Management Board is comprised of six members, selected from the Board of Supervisors, by the Board of Supervisors. One representative from the Commission and the Executive Director attend as non-voting participants (save for budgetary matters on which the Commission will also have a vote). The Management Board is chaired by ESMA’s full time Chair, based at ESMA’s premises in Paris. The Chair has an independent role and is not a representative of any Member State and is not an appointee of the European Commission. The Chair serves a five year term which may be extended once.

### What are the powers of ESMA?

ESMA’s role is to continue the work of CESR, but with new powers including, inter alia, the ability to draft technical standards (see below), the ability to launch fast-track procedures to ensure a consistent application of EU law, powers to resolve disagreements between national authorities. ESMA also have responsibilities around consumer protection, monitoring systemic risk emanating from cross border financial institutions, as well as supervisory role for financial agencies including, in particular, credit rating agencies.

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<sup>2</sup> Established by Commission Decision 2009/77/EC

<sup>3</sup> Regulation (EU) No 1095/2010 bringing ESMA into force.

ESMA may temporarily prohibit or restrict certain financial activities that “threaten the orderly functioning and integrity of financial markets or the stability of the whole or part of the financial system in the Union”<sup>4</sup>.

ESMA is obliged to take due account of the impact of its activities on competition and innovation within the EU, on the EU’s global competitiveness, on financial inclusion, and on the EU’s strategies for jobs and growth.

Although ESMA is independent, it has full accountability to the European Parliament, who may call it to appear for formal hearings, and to the European Council and European Commission.

Certain decisions of ESMA may be appealed to a Board of Appeal, composed of six members and six alternates whose members are appointed for a term of five years which may be extendable once. Members are relevant industry professionals with suitable high-level experience chosen from a shortlist, prepared by the European Commission, following a call for expression of interest. Decisions of the Board of Appeal are adopted on the basis of a majority of at least four of its six members. Where there is no right of appeal to the Board of Appeal from a decision taken by ESMA, appeals may be made to the European Court of Justice.

### ESMA and Securities Markets Legislation

Pursuant to a recommendation by the ‘Committee of Wise Men’ chaired by Alexandre Lamfalussy in Brussels in February 2001<sup>5</sup> EU securities markets legislation, is implemented by way of a four level process. ESMA is a key player in the implementation of EU legislation, in particular, in Levels 2 – 4 of this process.

At the first stage of this process is the issue of primary legislation by way of Directives and Regulations by the European Commission. EMSA may be consulted by the Commission in respect of technical advices as the Commission develops its legislative proposal. Following the issue of primary (or “Level 1”) legislation, ESMA will become involved in drafting Level 2 legislation, (known as delegated acts and implementing acts), which deal with the substantive requirements needed to bed down Level 1 Legislation. For example, Level 2 legislation may set out minimum requirements for authorisation as an EU regulated entity (for example an Alternative Investment Fund Manager (“AIFM”)) contemplated by Level 1 legislation, or set out templates on which European financial regulators can rely for the purposes of imposing minimum reporting standards on such regulated entities.

ESMA is the party which issues Level 3 implementing measures for Level 1 legislation. Such Level 3 measures comprise guidelines and recommendations, which may be addressed to European financial regulators or to participants in the European financial markets for implementing Level 1 and Level 2 legislation. The purposes of such guidelines is to establish “consistent, efficient and effective supervisory practices within the European System of Financial Supervision, and to ensure the common, uniform and consistent application of Union Law”<sup>6</sup>. Level 3 recommendations are not legally binding, however, European Regulators are bound by a “comply or explain” regime which means that any non-compliance by European Regulators with the Level 3 Guidelines must be explained to ESMA. Such measures are imposed to ensure that Level 3 regulations are applied uniformly throughout the EU. Given the “comply or explain” regime, ESMA’s role can be compare to that of a legislator, with similar far-reaching consequences.

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<sup>4</sup> Regulation Recital 12.

<sup>5</sup> [ec.europa.eu/internal\\_market/.../wisemen/final-report-wise-men\\_en.pdf](http://ec.europa.eu/internal_market/.../wisemen/final-report-wise-men_en.pdf)

<sup>6</sup> <http://www.esma.europa.eu/page/esma-short>

Level 4 is a new procedure introduced by the ESMA Regulation, through which ESMA can be requested to launch an enquiry and can issue a recommendation to a European Regulator within two months of launching an investigation. Although ESMA may launch such investigations on its own initiatives, such investigations may also be requested by a European Regulator, the European Parliament, the European Council, the European Commission<sup>7</sup> or a stake holder group.

### **ESMA – Overall Role**

ESMA contributes, through its work on securities legislation, to the development of a 'single rule book in Europe', promoting equal conditions for financial services providers across the EU, and ensuring the consistent treatment of investors in the EU. ESMA also contributes to the work of the European Systemic Risk Board, assisting in the identification of potential risks to the financial system and providing advice to diminish threats to the stability of the EU.

The primary function of ESMA as an independent authority is to safeguard the stability of the EU's financial system by ensuring the integrity, transparency, efficiency and orderly functioning of securities markets, as well as enhancing investor protection. ESMA's ongoing role in the implementation of the Alternative Investment Fund Manager Directive demonstrates the far-reaching influence of ESMA, even beyond the borders of the European Union. Such influence will need to be considered on an ongoing basis by the European Parliament, in order to ensure that in safeguarding the stability of the EU's financial system, EMSA does not inadvertently impose barriers to entry which may, in themselves, have a detrimental effect on the EU's financial system.

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<sup>7</sup> The Commission will not be estopped from its usual procedures around referring a case against a Member State to the Court of Justice.